

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of

Section 272(f)(1) Sunset of the BOC
Separate Affiliate and Related
Requirements

WC Docket No. 02-112

REPLY COMMENTS OF VERIZON

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I. Introduction and Summary.

The interexchange carriers seem to be caught in a time warp where it is still 1984 and the objective is to create a separate long distance market by keeping the Bell operating companies (“BOCs”) out of it. Their argument that the section 272 separate affiliate requirements should be extended until the BOCs are found to be non-dominant ignores the fact that Congress took a different route in the Telecommunications Act of 1996, choosing to open all markets to competition rather than walling them off from each other. Congress clearly adopted the separate affiliate requirement in section 272 as a transitional mechanism, to be retained only during the initial stage of opening the local market to competition. Because the record shows that competition is working, retention of separate affiliates can only harm competition by imposing highly burdensome and unnecessary costs on the BOCs, to the ultimate detriment of consumers.

¹ The Verizon companies (“Verizon”) are the affiliated local and long distance telephone companies of Verizon Communications Inc. These companies are listed in Attachment A.

The arguments about discrimination and cross-subsidization are beside the point. The Act addresses these issues directly, and so should the Commission. Separate affiliates are not needed to enforce the BOCs' obligations under sections 201, 202, or 251 to provide access services, interconnection, and unbundled network elements on a reasonable and nondiscriminatory basis. Nor are they needed to ensure that the BOCs properly allocate costs between local and long distance services and that they impute to their own long distance services the same rates for exchange access that they charge to other carriers.

The Commission should not adopt even a limited extension of the three-year sunset mandated by Congress. To do so, the Commission would have to establish concrete, post section 271 relief facts showing that extension is necessary to achieve a regulatory purpose. There are none. Verizon has shown that the costs of maintaining separate affiliates far outweigh any potential benefits.

Finally, regardless of whether the Commission decides to extend the sunset (which it should not), the Commission should eliminate immediately the prohibition from sharing operating, installation, and maintenance ("OI&M") services between the BOCs and the section 272 affiliates. This prohibition, which goes beyond the statutory requirements, represents the single greatest source of duplicative costs, depriving the BOCs of efficiencies that they could use to provide more competitive long distance services that would benefit consumers.

II. Proposals To Extend The Sunset Date Based On Market Share Are Contrary To The Congressional Scheme.

The interexchange carriers clearly hope to handicap their BOC competitors indefinitely, arguing that the separate affiliate requirement should be extended until the BOCs are found to be

non-dominant in the local exchange based on a loss of market share.² This is directly contrary to the congressional scheme in the Telecommunications Act of 1996, which is designed to remove regulatory barriers when markets are opened to competition, rather than when a particular group of competitors has more or less success in the marketplace. As the Commission has recognized, Congress specifically considered and rejected a market share test for BOC participation in the long distance business. *See, e.g., Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Michigan*, 12 FCC Rcd 20543, ¶ 77 (1997). Instead, Congress adopted specific market opening steps set out in the competitive checklist of section 271 of the Act. Likewise, Congress did not adopt a market share test for sunset of the separate affiliate requirement of section 272. Instead, Congress adopted the separate affiliate requirement as a transitional measure during the initial period after a BOC first receives long distance authority, and it established a presumption that this requirement would sunset in three years. To overcome this presumption, the Commission must be able to point to concrete post-section 271 relief facts showing that an extension is necessary. The comments do not establish any circumstances that warrant extension of the congressionally-mandated sunset. On the contrary, all objective facts show that it is not necessary.

If Congress had wanted to adopt non-dominance or market share loss as a requirement for sunset, it would have done so. In fact, it would not have had to address the issue of sunset at all,

² *See, e.g.,* AT&T, 7-10; WorldCom, 1-3; *see also* Time Warner, 21-25; New Jersey Ratepayer Advocate, 7-16. Although AT&T argues that sunset should be extended for a minimum of three years, its basic argument is that the separate affiliate requirement should not be lifted until the BOCs no longer have market power based on an unspecified loss of market share. *See* AT&T, 10. AT&T presumes that such market power would continue to exist well beyond an additional three years, warranting even more extensions. *See id.*, 49.

because section 10 of the Act already provides that the Commission may forebear from enforcing any section of the Act if that provision is no longer necessary to promote competition. *See* 47 U.S.C. § 160. Instead, Congress adopted a three-year sunset of the separate affiliate requirement, knowing that it was highly unlikely that a BOC would lose most of its customers by that time. In the Telecommunications Act of 1996, Congress did not attempt to engineer the competitive market or pick winners or losers. Rather, it chose market opening, rather than market share, as the criterion for granting the BOCs the ability to enter the in-region interLATA marketplace. Absent a clear reason to deviate from the congressional policy, which has not been shown, there is no basis for extending the separate affiliate requirement beyond the statutory sunset date.

Even the interexchange carriers admit that the separate affiliate requirement is a “belts and suspenders” measure, as its only function is to help monitor the BOCs’ compliance with the rules prohibiting them from discriminating in favor of their own long distance services and misallocating long distance costs to their local exchange services. *See, e.g.,* AT&T, 6-7.

However, it does so at a very high cost, preventing the BOCs from enjoying the economies of scale and scope that all other telecommunications providers are permitted by the Act, including the interexchange carriers, competitive local exchange carriers, wireless carriers, and cable companies, all of whom can and do provide integrated packages of local and long distance services. For this reason, Congress provided that the separate affiliate requirement sunsets in three years, while other safeguards remain unaffected. The continuing safeguards include the non-discrimination requirements of sections 202, 251(c), and 272(e)(1), the requirements for reasonable rates under sections 201 and 251(c), and the requirement in section 272(e)(3) that the BOCs impute to their own long distance services the same access charges that they apply to non-affiliated interexchange carriers. Requiring the BOCs to demonstrate that they have no market

power or have lost a specific amount of market share in the local exchange market before the separate affiliate requirement sunsets is clearly inconsistent with the congressional scheme.

The congressional result is a sensible one. Because the BOCs started out in 1996 with close to 100 percent share of the local market, it is to be expected that they would continue to have a relatively high market share after only a few years of entry by competitors under the 1996 Act's market opening provisions. Nonetheless, the large and continuing declines in the BOCs' shares of the local markets and in their total number of access lines demonstrate that the competitive model envisioned by Congress is working.

Moreover, the BOCs are facing competition in ways that were not envisioned in 1996 and that are not captured in simple market share statistics. For example, customers have begun to abandon their wireline phones for wireless phones. Today, close to one in five customers views a wireless phone as their "primary" phone.³ Customers are also using e-mail and other Internet-based services to communicate in place of traditional phone service.

Not only do market share measures miss all of the competitive alternatives, but they fail to reflect prospective changes in traditional competition. Market share can only reflect past actions, not the future conduct.⁴ Once barriers to entry have been removed, a firm's current market share says nothing about its ability to resist competitive challenges.

³ *Verizon Wireless' Petition for Partial Forbearance from the Commercial Radio Services Number Portability Obligation*, WT Docket No. 01-184, Memorandum Opinion and Order, FCC 02-215, ¶ 17 (rel. July 26, 2002).

⁴ *See Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Georgia and Louisiana*, CC Docket No. 01-277, Reply Affidavit of William E. Taylor on Behalf of BellSouth, 43 (filed Nov. 13, 2001) ("Taylor Affidavit"). A better measure of market power is the "contestability" of a market. *See id.* The 1996 Act minimized the entry and exit costs for the

Given their myopic view of the competitive pressures faced by the BOCs, it should not be surprising that AT&T argues that, even in New York, where Verizon has lost 25 percent of the local exchange market to competitive local exchange carriers, local competition is not “significant,” while it professes to be highly alarmed that Verizon has obtained a 34 percent share of the interLATA market in New York. *See* AT&T, 15-16 & Selwyn Declaration, ¶ 39.

Apparently, AT&T’s assessment of the significance of market share depends on whose ox is being gored. Viewed objectively, both figures represent healthy competition and the expected results of new entry once regulatory barriers are removed.

Indeed, the data on market share support the view that the market opening measures of the Act are working in the states where long distance authority has been granted. In all of the markets where Verizon has obtained section 271 authority, its market share has declined steadily, and the number of lines served by CLECs has grown. For example, the CLEC market share in New York rose from 13.2 percent in January 2000, shortly after Verizon obtained section 271 authority, to 28.5 percent in June 2002.⁵ Similarly, the CLEC market share in Massachusetts

local exchange market by eliminating regulatory entry barriers and by giving potential entrants low cost options, such as resale and unbundled network elements, which make it easy for competitive local exchange carriers to exploit any attempt by a BOC to sustain supra-competitive rates.

⁵ This is based on internal estimates using the numbers of resold lines, UNE platform, and E911 listings for CLECs to estimate the number of CLEC lines. CLEC market share is based on total CLEC lines divided by CLEC lines plus Verizon retail lines. AT&T argues (at 16) that the CLEC “penetration rate” in New York decreased in the second quarter of 2001. However, Verizon’s own data show that the CLEC market share increased from 25.1 percent in the first quarter of 2001 to 26.1 percent at the end of the second quarter of 2001, and that it has steadily increased each quarter since that time. This trend is also confirmed by the Commission’s Local Competition Report. *See* Local Telephone Competition: Status as of December 31, 2001, Table 7 (rel. July 2002).

rose from 17.7 percent in April 2001, when Verizon obtained section 271 authority in that state, to 22.0 percent in June 2002, little more than a year later.

The interexchange carriers argue that the recent series of financial retrenchments by the CLECs have eliminated them as a serious competitive challenge to the BOCs. *See* AT&T, Selwyn Affidavit, ¶¶ 74-76. However, despite the fact that the absolute number of CLECs has declined in the last two years, the total number of lines served by CLECs and their market share have continued to grow, while the incumbent local exchange carriers' total lines and their market shares have continued to decline. *See* Local Competition Report, Table 1. In addition, the challenge from the CLECs is in addition to the substantial diversion of wireline customers to wireless carriers, which has contributed to the three-year decline in the number of lines served by the incumbent local exchange carriers, a trend that has never occurred before. *See* Verizon, 6-7. These facts prove that the local exchange markets are irretrievably open and that there is no reason to extend the separate affiliate requirement beyond the three years mandated by Congress.

III. Market Evidence Shows That Extending The Separate Affiliate Requirement Is Unnecessary And Unjustified.

As Verizon demonstrated in its comments, the separate affiliate requirement imposes massive costs that ultimately must be borne by consumers. *See* Verizon, 9-11. The interexchange carriers breezily dismiss the costs of separate affiliates, claiming that they are minimal and apparently have not impeded the BOCs in competing for long distance customers. *See, e.g.,* AT&T, 47-48; WorldCom, 7. To the contrary, Verizon demonstrated that its own costs of complying with the separate affiliate rules are over a billion dollars over a nine-year period due to the duplication of facilities and labor that could be avoided without separate affiliates.

See Verizon, 9-10; *see also* SBC, 5-8. There is no need to perpetuate this economic waste. The fact that the BOCs have been successful to some degree in attracting long distance customers after obtaining section 271 authority despite being burdened by these costs does not mean that it has not had an adverse impact on the ability of the BOCs to compete. There is no free lunch. The consumer inevitably pays for these wasted costs to the extent that they restrict the BOCs' ability to invest, innovate, and provide the most competitive rates and services.

In addition to the interexchange carriers, who want to retain the section 272 separate affiliate requirements until some point in the indefinite future when the BOCs are found to be non-dominant, some commenters argue for more limited extensions of from one to three years. *See, e.g.*, CompTel, 20-22; Sprint, 3-4; Texas PUC, 2; Wyoming PSC, 2; Pennsylvania PUC, 5-6. They argue that deferral of sunset would allow consideration of the results of the second biennial audit, that enough has not changed in the local exchange market since the BOCs obtained interLATA authority, and that a longer extension is warranted by the results of the biennial audits. The Commission should not adopt any of these proposals. Congress did not establish any criteria or "checklist" of changed circumstances that must be met prior to sunset, and it certainly contemplated that only one full biennial audit would be completed before the three year sunset period expired. In addition, Verizon's own biennial audit showed that it has complied with the section 272 safeguards.⁶

⁶ *See also* PricewaterhouseCoopers, Section 272 Biennial Agreed-Upon Procedures Engagement, CC Docket No. 96-150 (filed June 11, 2001), Verizon Response to Section 272 Audit Report, CC Docket No. 96-150 (filed June 10, 2002) ("*Verizon 272 Audit Response*"). The biennial audit, which was performed under "agreed-upon procedures," noted all results, regardless of materiality. As Verizon demonstrated in its comments on the report and in its reply to the comments of other parties, despite the minor administrative errors and other items noted by

The requests for extension are based, in part, on the assumption that it would be “costless.” *See, e.g.*, WorldCom, 7-10; AT&T, 47-48. The commenters argue that there are no efficiency losses associated with the section 272 separations rules due to Commission's rules allowing the sharing of services and facilities other than OI&M services and the joint ownership of switching and transmission facilities. However, as Verizon's comments demonstrate, even a one-year extension of the separate affiliate requirements would be highly burdensome, costing over \$135 million per year for Verizon alone in duplicative costs. *See* Verizon, Howard Declaration, ¶ 4 (\$550 million in expenses over the next four years). This economic waste cannot be justified, especially in the current economic environment. Clearly, the costs of extending the separate affiliate requirement grossly outweigh any potential benefits. Because the only alleged benefit of the separate affiliate requirement is enforcement of rules against discrimination and cross-subsidization, which will be enforced in any event through direct monitoring of performance and cost accounting regardless of whether there is a separate affiliate, any extension of the separate affiliate rules fails a cost/benefit analysis.

The interexchange carriers argue that the separate affiliate requirement must be maintained so long as competitors rely upon the BOCs for inputs such as special access services in order to provide long distance services. *See, e.g.*, AT&T, 15-16, 20; Sprint, 8-9. However, competitive alternatives are numerous and growing in all markets where the BOCs have gained section 271 authority. As noted by SBC (at 17), in 2001, just two years after the Commission adopted its pricing flexibility order, collocation by facilities-based competitors (including interexchange carriers) was so prevalent that 80 percent of BOC special access revenues

the auditors, the audit report shows that Verizon has a comprehensive and effective program for complying with the Commission's section 272 rules.

qualified for pricing flexibility. Verizon's own data show that CLECs use their own fiber networks to capture between 28 and 39 percent of all revenues for special access services, in addition to their use of UNE loops and transport to undercut BOC prices for special access services. *See* 2002 UNE Fact Report, CC Docket No. 01-338, I-3, I-13 (filed April 5, 2002). The CLECs have rapidly expanded their local fiber networks, from approximately 100,000 route miles in 2000 to at least 184,000 route miles today. *See id.*, III-6. Today, 91 of the top 100 metropolitan statistical areas are served by at least three CLEC networks. *See id.*, III-7. Clearly, the interexchange carriers have competitive alternatives to the BOCs' special access services, which prevents the BOCs from even attempting to use their provision of these services to inhibit competition in the interexchange market.

Moreover, even assuming that some competitors rely upon the BOCs' services, this does not provide any justification for continuing the separate affiliate requirements. In many other markets where competitors rely upon the BOCs in part, or even exclusively, for inputs to their services, competition has thrived despite the fact that the Commission has allowed the BOCs to compete in these markets without separate affiliates. There is nothing about the long distance market that would produce a different result.

For example, the Commission has allowed the BOCs to provide customer premises equipment, inside wire services, payphones, information services (both intraLATA and interLATA), and intraLATA toll services without using separate affiliates, despite the fact that competitors or their customers in these markets often use the BOCs as an essential input into the

provision of these services.⁷ In all of these markets, competition has thrived, the numbers of competitors have burgeoned, output has increased, prices have fallen, and customers have benefited. *See, e.g., 1998 Biennial Regulatory Review – Review of Customer Premises Equipment and Enhanced Services Unbundling Rules*, 16 FCC Rcd 7418, ¶ 10 (2001) (“CPE/Enhanced Services Bundling Order”) (“The state of competition in the CPE and enhanced services markets is drastically different from the state of competition in those markets in 1980. . . consumers who choose to purchase CPE or enhanced services on a stand-alone basis may do so from a myriad of suppliers [including] a wide choice of interexchange carriers and a growing choice of local exchange carriers”). For example, since BOC entry into the enhanced services market, the voice messaging industry has grown at double-digit rates and monthly service fees have dropped significantly.⁸ Growth has been even more explosive in Internet access; today, there are more than 7,000 Internet service providers.⁹ The deregulation of computers and other

⁷ *See, e.g., Amendment of Sections 64.702 of the Commission’s Rules and Regulations (Third Computer Inquiry)*, 104 F.C.C.2d 958 (1986) (removing structural safeguards for BOC provision of enhanced services); *Furnishing of Customer Premises Equipment by the Bell Operating Telephone Companies and the Independent Telephone Companies*, 2 FCC Rcd 143 (1987) (removing structural separation for BOC provision of customer premises equipment); *Detariffing the Installation and Maintenance of Inside Wiring*, 5 FCC Rcd 3407 (1990) (detariffing and deregulating the installation and maintenance of inside wiring); *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 20541, ¶ 237 (1996) (retaining nonstructural safeguards for BOC provision of payphones); *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 1996 FCC LEXIS 4311 (1996) (implementing intraLATA toll dialing parity).

⁸ *See* J.A. Hausman and T.J. Tardiff, *Benefits and Costs of Vertical Integration of Basic and Enhanced Telecommunications Services* at 14, attached to Comments of Bell Atlantic, *Computer II Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services*, CC Docket No. 95-20 (filed Apr. 7, 1995).

⁹ *See Boardwatch Magazine’s Directory of Internet Service Providers* at 4 (13th ed. Spring 2001).

customer premises equipment has resulted in rapidly falling prices for information technology which, together with development of the Internet, has fueled a spectacular rise in productivity growth.¹⁰ This began happening even before enactment of the Telecommunications Act of 1996, when many of the inputs needed for these services, such as access to network interface devices, access lines, and dial-up connections, arguably were in the exclusive control of the incumbent local exchange carriers. Most significantly, the Commission allowed the separate affiliate requirement for in-region, interLATA information services to sunset almost two and a half years ago, and no party alleges that the BOCs have used this to impede competition in that market. *See Request for Extension of the Sunset Date of the Structural, Nondiscrimination, and Other Behavioral Safeguards Governing Bell Operating Company Provision of In-Region, InterLATA Information Services*, 15 FCC Rcd 3267, ¶ 3 (2000). The arguments of the interexchange carriers that the BOCs would extend their alleged control of exchange access services to impede competition in the interLATA market without a separate affiliate requirement flies in the face of consistent experience in other markets where similar allegations have proven false.

In fact, every indication is that the same pattern is occurring in the interLATA market as well. In all markets where the BOCs have gained section 271 authority, competition has increased in the interLATA market and consumers have benefited. In response to the increased competition from the BOCs and their offers of new competitive pricing alternatives such as no-

¹⁰ *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, *Structural Changes in the Economy and Financial Markets*, remarks before the America's Community Bankers Conference, New York (Dec. 5, 2000); J. Oxman, *The FCC and the Unregulation of the Internet* at 14, Office of Plans and Policy, OPP Working Paper No. 31, (July 1999) ("Most important for the growth of the Internet, the Commission's deregulation of customer premises equipment, or CPE, cleared the way for rapid growth of the modem.").

minimum monthly fee plans, the interexchange carriers have entered the local exchange market and have offered their own new pricing plans that offer packages of local and long distance calling.

Competition will continue to flourish in the interLATA market after the separate affiliate requirement sunsets for the same reason that competition has flourished in other markets where the BOCs are both competitors and suppliers of inputs to their competitors – the Commission retains abundant authority under the Act to ensure that the BOCs provide these inputs on reasonable and non-discriminatory rates, terms and conditions. The continuing safeguards include the non-discrimination requirements of sections 202, 251(c), and 272(e)(1), the requirements for reasonable rates under sections 201 and 251(c), and the requirement in section 272(e)(3) that the BOCs impute to their own long distance services the same access charges that they apply to non-affiliated interexchange carriers. The provisions of sections 201, 202, 251, and 272 and the Commission's rules implementing them impose special obligations on the BOCs that are designed to ensure that they provide their competitors in both the local and interexchange markets with the services and facilities they need to provide competitive telecommunications services. In crafting the Telecommunications Act of 1996, Congress clearly viewed these provisions as sufficient to protect competition after the separate affiliate requirement sunset in three years.

For example, section 272(e)(1) requires a BOC to fulfill requests for telephone exchange service and exchange access within a period no longer than it provides such service to itself or an affiliate. Any discrimination in favor of the BOC's retail services would have to be apparent to customers to give a BOC an unfair advantage in the marketplace, and any discrimination that was

apparent to customers would also be easily detected by the BOCs' competitors as well as by the Commission.

Similarly, section 272(e)(3) deals with potential cross-subsidization by requiring a BOC to impute to itself, or to its separate affiliate, the same amount for exchange access that it charges unaffiliated carriers. The BOCs would assign the same costs to their long distance operations regardless of whether or not they use separate affiliates. Moreover, the Commission has a great deal of experience with cost accounting between regulated and non-regulated BOC activities. For example, in its order allowing the bundling of enhanced services, the Commission found that its cost allocation rules are effective in preventing cross-subsidization of competitive services by non-competitive services, and that its section 202 authority is sufficient to enforce the BOCs' obligation not to discriminate against their competitors. *See CPE/Enhanced Services Bundling Order*, ¶¶ 38, 46. There is no reason to conclude that such cost accounting would be less effective for long distance services than it has been for those other, no less competitive services.

The commenters who advocate indefinite extension of the separate affiliate requirements argue that it is necessary to detect discrimination and cross-subsidization by the BOCs in favor of their own long distance services. *See, e.g.*, CompTel, 16-18; WorldCom, 6; AT&T, 43. It is not. Discrimination and cross-subsidization can be monitored effectively whether or not the BOC provides a service to a separate affiliate or to itself (i.e., to its own retail customers).

The interexchange carriers' claims that these safeguards will be ineffective without separate affiliates are not availing. For example, the carriers point to the results of the section 272 audits to argue that Verizon, for one, is discriminating against non-affiliated interexchange carriers and has misallocated its long distance costs to its local exchange services. *See, e.g.*,

AT&T, 26-27, 31-32, 38; CompTel 9-12. They apparently are so enamored of these arguments that they simply chose to ignore Verizon's response in the section 272 audit proceeding, where Verizon demonstrated that no discrimination had occurred and that Verizon had complied with the affiliate transaction rules.¹¹ To assist the Commission here, Verizon attaches to these comments a point-by-point rebuttal to the allegations about Verizon's section 272 audit. *See* Attachment B. While these points have been previously raised by Verizon, they are ignored by parties attacking Verizon, rendering those attacks devoid of substance.

The section 272 audit reports are irrelevant in any event. If the Commission allowed the separate affiliate rules to sunset, it could still audit the BOCs' compliance with the rules for allocating costs between local and long distance services. The Commission would lose nothing in its ability to monitor compliance with its rules. The interexchange carriers have also failed to explain how Verizon might benefit, or how competition would be harmed, by a change in the allocation of cost between Verizon entities. Such a shift would not reduce Verizon's total cost. Nor would it increase Verizon's revenue. Because Verizon's BOCs operate under price cap regulation, an increase in expenses booked to the BOC would not create any new opportunity to raise prices, and thus would not allow any cross-subsidization of Verizon's long-distance service. *See CPE/Enhanced Services Unbundling Order*, ¶ 38 ("incumbent LECs that are subject to price cap regulation in both state and federal jurisdictions do not have an incentive to shift unregulated

¹¹ *See Verizon 272 Audit Response*". AT&T also throws in its old complaint that Verizon illegally subsidized Genuity by lending it more money than was allowed by the merger conditions. *See* AT&T, 23 n.27. Verizon refuted that claim in a letter to the Commission, demonstrating that AT&T had misinterpreted the financing limits in the merger conditions. *See* Application of GTE Corp. & Bell Atlantic Corp., CC Docket No. 98-184, Letter of Gordon R. Evans to Dorothy Attwood, Chief, Common Carrier Bureau (dated September 18, 2001).

CPE costs because absent a guaranteed rate-of-return on their local exchange investment, these carriers cannot expect to recover CPE discounts by including them in their regulated rate base”).

Some commenters argue that, aside from the issue of discrimination, the Commission should extend the separate affiliate requirement because the overall quality of the BOCs’ special access services is inferior or declining. *See, e.g.*, AT&T, 27-29; CompTel, 7-9. Special access service quality is simply irrelevant to the issue of extending the sunset date. Regardless of whether the BOCs use separate affiliates to provide long distance services, or whether they offer long distance services at all, there is no need to retain separate affiliates in order to ensure that the BOCs provide a reasonable level of service quality for special access.

The interexchange carriers’ comments demonstrate that their real concern about elimination of the separate affiliate requirement is that the BOCs will enjoy the efficiencies that Congress specifically intended for all carriers to enjoy by allowing joint provision of local and long distance services. The interexchange carriers are trying to keep the industry in the 1984 post-divestiture environment that keeps local and long distance carriers out of each other’s markets. Congress specifically rejected this approach when it enacted the Telecommunications Act of 1996, permitting all carriers to enter all markets and vertically integrate their services. It would be anticompetitive to use the separate affiliate requirement as a counterweight to the BOCs’ ability to engage in joint marketing.

The interexchange carrier’s mindset is typified by the Selwyn Declaration attached to AT&T’s comments. Dr. Selwyn argues that the BOCs have an anticompetitive advantage in the interLATA market due to their ability to jointly market local and long distance services. *See* Selwyn Affidavit, ¶¶ 36-42. Joint marketing cannot be considered anticompetitive – it was

specifically permitted by Congress and approved by the Commission. *See* 47 U.S.C. § 272(g)(1) & (2); *Non-Accounting Safeguards Order*, 11 FCC Rcd 21905, ¶¶ 286-87, 291-93, 296 (1996) (“*Non-Accounting Safeguards Order*”). Congress clearly believed that joint marketing would promote competition, because both BOCs and incumbent interexchange carriers would be able to enter each other’s markets and provide “one-stop shopping.” This is evidenced by the fact that Congress sought to create a level playing field by including a provision in the Telecommunications Act of 1996 that prohibited the major interexchange carriers from engaging in joint marketing of interLATA services with resold BOC local exchange services until the BOC received long distance authority in that state or until three years, whichever came first. *See* 47 U.S.C. § 271(e)(1).

Nonetheless, Dr. Selwyn claims that the joint marketing rule gives the BOCs the ability to “leverage” their positions in the local exchange market to dominate the long distance market. *See* Selwyn Affidavit, ¶ 44. In fact, each of the major existing players in the telecom market – large interexchange carriers, cable, wireless, and incumbent local exchange carriers – have existing customer bases, which may give each of these companies some economies in joint marketing. The safeguards in the Act are intended only to prevent unlawful discrimination, not to reduce real efficiencies, or to handicap any of these competitors. In any event, because the BOCs are permitted to conduct joint marketing of local and long distance services regardless of whether they have separate affiliates, Dr. Selwyn’s arguments provide no support for continuing the separate affiliate requirement. If Dr. Selwyn is arguing that the Commission should retain the separate affiliate rule as a handicap on the BOCs to offset the joint marketing rule, this is clearly contrary to the pro-competitive goals of the Telecommunications Act of 1996. If that indeed is the purpose of the separate affiliate requirement, it should be eliminated immediately.

Dr. Selwyn's analysis provides further evidence that AT&T's insistence on continuing the separate affiliate requirement is motivated by a desire to handicap its competitors rather than to enforce the Commission's rules. Dr. Selwyn argues that by offering both local and long distance services, the BOCs and their separate affiliates are motivated to offer a lower combined price than if they offered these products separately – and that this is a bad thing. *See* Selwyn Affidavit, ¶¶ 49-61. Most economists, and certainly almost all consumers, would disagree. One of the primary benefits of vertical integration is increased efficiency, which can translate into lower prices, better services, and other improvements that inure to the benefit of consumers. For this reason, the Commission has allowed the BOCs and other carriers to offer regulated and non-regulated services and products on a bundled basis at discounted rates that are lower than the sum of the separate prices.¹² In any event, this argument has no relevance to whether the separate affiliate rule should sunset, because Dr. Selwyn opposes joint marketing by the BOCs regardless of whether or not they offer long distance service in separate affiliates.

Dr. Selwyn argues further that the BOCs' long distance affiliates are violating the requirement of arms-length transactions by pricing their long distance services too low, and that they would not do this unless they were acting "in concert" with the BOCs.¹³ As evidence, he

¹² *See CPE/Enhanced Services Unbundling Order*, ¶¶ 10-12. Dr. Selwyn claims (at ¶ 60) that the BOCs' offering of local and long distance services at a lower price than they would offer for these services separately is an unlawful "tying" arrangement. However, the Commission has found that such bundled pricing is not anticompetitive where, as here, the BOCs offer the basic telephone exchange service on an unbundled basis, with no requirement that a customer purchase the long distance services in order to obtain the local exchange services. *See CPE/Enhanced Services Unbundling Order*, ¶ 18.

¹³ As an example, Dr. Selwyn argues that Verizon's long distance affiliate is not pricing its services sufficiently high to cover the \$1.15 per bill charge that it pays the Verizon BOC for billing and collection. *See* Selwyn Affidavit, ¶¶ 53-54. In this case, Dr. Selwyn is not claiming that Verizon is violating the affiliate transaction rules, because the Verizon long distance

points to Verizon's offering of long distance pricing plans without a minimum monthly service charge, which he claims cannot cover the long distance affiliate's costs. *See* Selwyn Affidavit, ¶ 57. Apparently, he is unaware that this was a condition of the Commission's approval of the Bell Atlantic/GTE merger and one which the Commission found would provide public benefits that would help justify approving the merger.¹⁴ Something AT&T sees as a threat to competition is actually a legal requirement as well as a benefit to consumers.

Furthermore, the argument that it is anticompetitive for the BOCs to offer lower prices for combinations of local and long distance service ignores the fact that other providers in the industry have the same incentives Dr. Selwyn ascribes to the BOCs, and that they do the same thing. For instance, MCI offers its "The Neighborhood" plan that provides unlimited local calls, unlimited local toll calls, unlimited long distance calls, custom calling features, and voice mail for a fixed monthly price.¹⁵ Wireless carriers offer plans that include long distance calling in the

company is paying the same billing and collection rate as non-affiliated carriers. Rather, he is arguing (with no actual facts to support it) that the Verizon long distance company ignores this cost because it "knows" that the real incremental cost to the Verizon BOC is near zero. In fact, the costs are not zero – Verizon's comments in this proceeding show that the incremental billing cost for the long distance portion of the bill is projected to be \$91 million from 2003 through 2006. *See* Verizon, 10. This primarily represents the cost of creating a separate page for the long distance charges. Clearly, recovery of such significant costs cannot be ignored.

¹⁴ *See Bell Atlantic/GTE Merger Order*, 15 FCC Rcd 14032, ¶ 324, Appendix D, ¶ 49 (2000). Dr. Selwyn also claims that Verizon has failed to meet its commitments for out-of-region competitive entry. *See* Selwyn Affidavit, ¶ 31. However, the independent audit of Verizon's merger commitments for 2001 confirmed that Verizon is meeting the required out-of-region expenditures. *See Bell Atlantic/GTE Merger*, CC Docket No. 98-184, PricewaterhouseCoopers, Report of Independent Accountants (filed June 3, 2002); *see also Bell Atlantic/GTE Merger*, CC Docket No. 98-184, Order, FCC 02-188 (rel. June 24, 2002).

¹⁵ http://www.theneighborhood.com/res_local_service/jsps/default.jsp.

airtime charges for no additional charge.¹⁶ This is a sign of healthy competition, as the carriers are passing along to their customers the economies of scale and scope from vertically integrated service packages. There is no reason to conclude that the BOCs are acting anti-competitively or are failing to comply with the separate affiliate rules when they do the same.

If anything, these arguments show that extending the separate affiliate beyond sunset would harm competition and the consumer interest. Even AT&T's economist sees it primarily as a financial handicap on the BOCs rather than as a means of enforcing the Commission's rules. Sunset would promote competition in both the local and long distance markets and improve the consumer welfare by eliminating economic waste and artificial impediments on one group of long distance service providers.

IV. Regardless Of The Conclusion On Sunset Generally, The Commission Should Eliminate Its Prohibition On The Sharing Of Operating, Installation, And Maintenance Services.

Verizon's comments demonstrate that in addition to allowing the separate affiliate rules to sunset as scheduled, the Commission should eliminate the OI&M restriction immediately for all BOCs. *See* Verizon, 15-21. The OI&M restriction is the single greatest source of duplicative costs caused by the section 272 rules. As Verizon demonstrated, the OI&M restriction has and will cost Verizon about one half of a billion dollars. *See* Verizon, 17. The Commission adopted this rule solely because it was concerned about its ability to monitor cost allocations for BOC employees that perform OI&M services on both local exchange facilities and long distance

¹⁶ AT&T was one of the pioneers of wireless plans offering no separate long distance charges for long distance calls. *See, e.g.,* http://www.attws.com/personal/ps/select_plan_minutes.jhtml?offerType=RA.

facilities. *See Non-Accounting Safeguards Order*, ¶ 163. However, it could not have contemplated that the costs of compliance would be so excessive. Moreover, these costs are completely unnecessary. The Commission has relied effectively on its cost allocation rules to ensure that the BOCs properly allocate their costs to other services no less competitive than long distance services. Cost accounting alone has been sufficient to ensure development of competitive markets for customer premises equipment, inside wiring, information services, and other services where BOC personnel work on both regulated and nonregulated equipment and facilities. Moreover, the BOCs already compete with the interexchange carriers in the intraLATA toll market without being required to employ a separate workforce to install, operate and maintain toll facilities. The Commission's experience with other nonregulated services provides ample evidence to support elimination of the OI&M rule.

Regardless of whether the Commission allows the separate affiliate rules to sunset as scheduled or extends the rules, it should eliminate the OI&M rule for all BOCs insofar as they still are required to maintain section 272 affiliates. Elimination of the rule would allow the BOCs to save hundreds of millions of dollars that could be used to provide better long distance service. For all other services, the Commission recognized that the Act does not prohibit the BOC and the separate section 272 affiliate from sharing such services, or from obtaining them from a common service affiliate. *See Non-Accounting Safeguards Order*, ¶¶ 178-82. The Commission found that the section 272(b)(3) requirement that a BOC and a section 272 affiliate have separate officers, directors, and employees does not bar the sharing of services, and that without such sharing, the BOCs would be unable to achieve the economies of scale and scope inherent in offering an array of services. The Commission stated that “[w]e do not believe that the competitive benefits of allowing a BOC and a section 272 affiliate to achieve such

efficiencies are outweighed by a BOC's potential to engage in discrimination or improper cost allocation" and that "with an appropriate accounting system, whatever administrative efficiencies may exist are preserved." Id., ¶ 179. There is simply no basis for continuing to exclude OI&M functions from the same structure. The Commission should do so by "sunsetting" the OI&M restriction or by granting Verizon's companion petition for forbearance.

Conclusion

The record provides no basis for extending the three-year statutory sunset of the section 272 separate affiliate rules. In addition, the Commission should eliminate the OI&M restriction immediately for all BOCs.

Respectfully submitted,

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Attorney for the Verizon companies

Dated: August 26, 2002

THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Midwest Incorporated d/b/a Verizon Midwest
GTE Southwest Incorporated d/b/a Verizon Southwest
The Micronesian Telecommunications Corporation
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Hawaii Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.

I. REBUTTAL TO CRITICISMS OF VERIZON'S SECTION 272 AUDIT REPORT

The interexchange carriers argue that the biennial audit of Verizon's compliance with the section 272 safeguards demonstrates that Verizon is discriminating against non-affiliated interexchange carriers and that it is misallocating long distance costs to its local exchange services. *See, e.g.*, AT&T, 26-27, 31-32, 38; CompTel 9-12. These comments simply ignore the fact that Verizon refuted similar criticisms leveled earlier by the interexchange carriers when the section 272 audit report was released. *See* Response of Verizon to Comments on Biennial Section 272 Audit Report, CC Docket No. 96-150 (filed June 10, 2002) ("*Verizon 272 Audit Response*").

For instance, they argue that the audit report shows that it takes Verizon substantially longer to process presubscribed interexchange carrier ("PIC") change orders for non-affiliates than for affiliates. *See, e.g.*, AT&T, 31; CompTel, 12. They totally ignore the fact that Verizon performed a special study in 2001 that proved that the difference in PIC order processing intervals is due to the time of day that interexchange carriers submit their orders to Verizon. *See Verizon 272 Audit Response*, 9-13. Despite the fact that Verizon informed the interexchange carriers in October 2000 that PIC orders submitted during the nightly "downtime" period for system maintenance would be held for several hours until the maintenance period was over, some interexchange carriers continued to submit orders just before or during that period, resulting in longer than average processing intervals. Interexchange carriers who submitted orders in the morning

hours, as Verizon's long distance affiliates did, had PIC processing intervals similar to Verizon's affiliate.¹ Having no rebuttal to this study, the interexchange carriers simply ignore it in hopes that if they fling enough accusations at the wall, something will stick.

Similarly, the interexchange carriers repeat their complaints that Verizon's audit shows it discriminates in favor of its affiliates in the provision of special access, complaining that, in a number of months, Verizon affiliates received 100 percent on time performance while the unaffiliated companies never did. *See, e.g.,* AT&T, 26-27. AT&T dismisses the fact that the number of orders for Verizon's affiliates were too small to be statistically significant. But it does not take a statistician to appreciate the fact that if Verizon had only two orders for high speed special access in July, and both were installed on time, the 100 percent on-time performance figure for that month is no more relevant than the 33 percent on-time performance that the affiliate received in April, when only one of its 3 orders was installed on time. Both numbers are too small to be compared to the average percent on-time performance for 3,000 to 4,000 monthly orders for non-affiliates.

AT&T also complains that the audit revealed Verizon's non-compliance with the affiliate transaction rules, because Verizon did not calculate fair market value for certain joint marketing services provided by the BOC to Verizon's long distance affiliates. *See*

¹ CompTel argues (at 17 n.26) that the difference in PIC intervals is due to the fact that the Verizon long distance affiliate uses a different process than unaffiliated long distance carriers to submit PIC orders. In fact, the section 272 audit measured PIC intervals using the same electronic PIC order submission process. The evidence shows that the differences among carriers, whether affiliated or non-affiliated, are due to the different times of the day that they submit PIC orders through the same electronic systems.

AT&T, 38, Selwyn Declaration, ¶ 65. As the audit report notes, Verizon employed an independent certified public accounting firm (other than the firm performing the section 272 audit) in an attempt to develop fair market value for these services, but the accounting firm could not do so because the services were unique and could not be compared to any services offered by third parties. *See* Verizon Section 272 audit, CC Docket No. 96-150, p. 21 (filed June 11, 2001). Since a comparison with fair market value could not be obtained, Verizon used fully distributed cost to charge these services to the long distance affiliate, as is required by the Commission's rules. *See* 47 C.F.R. § 32.27.

AT&T claims that Verizon's billing of joint marketing at fully distributed cost is unrealistically low. But its "analysis" is paper thin and misleading. AT&T's economist claims to be "aware of at least one analysis that has put [customer acquisition] costs at 'up to \$300 to \$600 in sales support, marketing and commissions' per customer acquired," and he uses this to argue that the \$7.71 payment that Verizon long distance makes to the Verizon BOC for a consumer customer contact is below fair market value. *See* AT&T, Selwyn Declaration, ¶ 64. First, the \$300 to \$600 estimate is based on a magazine article speculating about internal costs that interexchange carriers experience, which is not a sufficient basis for setting fair market value for a service sold to an outside company. Second, it includes a full range of activities for sales support, marketing, and commissions, while the \$7.71 charge to Verizon long distance is for a "customer contact," which can be a brief contact during a service order, status inquiry, error

correction, etc.² Third, by focusing on this single fee, AT&T grossly understates the costs that the Verizon BOCs charge to the long distance affiliates for joint marketing activities. These costs include \$6.22 to \$12.98 per contact for sales support, \$17.02 to \$29.20 for customer correspondence, \$519.63 to \$951.53 per student, per-day, to train BOC sales representatives on the long distance products, \$24,933.56 to \$41,829.00 per student to train new BOC personnel that are added as the result of increased long distance call volumes, and many other charges that go on the long distance affiliate's account. *See id.* Fourth, those charges are only for consumer accounts. For business accounts, per-sale fees, which include sales negotiation and acquisition, bid development, service order processing, and sales retention, run from \$1,237.75 to \$8,959.82 per sale, plus an annual commission pool of as much as \$405,105.75.³ AT&T's claim that Verizon charges its long distance affiliate a "minute fraction" of the fair market value of customer acquisition services deliberately ignores the evidence to the contrary.

² *See* <http://www.verizonld.com/pdfs/exhibit46zhAmendment34.pdf>.

³ *See* <http://www.verizonld.com/pdfs/jma33rates.pdf>.